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BEFORE THE ARIZONA CORPORATION COMMISSION
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CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE JOINT
APPLICATION BETWEEN CITIZENS
UTILITIES COMPANY; AGUA FRIA
WATER DIVISION OF CITIZENS
UTILITIES COMPANY; MOHAVE WATER
DIVISION OF CITIZENS UTILITIES
COMPANY; SUN CITY WATER
COMPANY; SUN CITY SEWER
COMPANY; SUN CITY WEST UTILITIES
COMPANY; CITIZENS WATER
SERVICES COMPANY OF ARIZONA;
CITIZENS WATER RESOURCES
COMPANY OF ARIZONA; HAVASU
WATER COMPANY AND TUBAC
VALLEY WATER COMPANY, INC., FOR
APPROVAL OF THE TRANSFER OF
THEIR WATER AND WASTEWATER
UTILITY ASSETS AND THE TRANSFER
OF THEIR CERTIFICATES OF PUBLIC
CONVENIENCE AND NECESSITY TO
ARIZONA-AMERICAN WATER
COMPANY AND FOR CERTAIN
RELATED APPROVALS.

Docket No. W-01032A-00-0192
Docket No. W-01032B-00-0192
Docket No. W-01032C-00-0192
Docket No. W-01656B-00-0192
Docket No. SW-2276A-00-0192
Docket No. WS-02334A-00-0192
Docket No. WS-03454A-00-0192
Docket No. WS-03455A-00-0192
Docket No. WS-02013A-00-0192
Docket No. W-01595A-00-0192
Docket No. W-01303A-00-0192

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Direct Testimony of Gordon Fox, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 14th day of August, 2000.

Daniel W. Pozefsky
Attorney, RUCO

1 AN ORIGINAL AND TEN COPIES
2 of the foregoing filed this 14th day of
3 August, 2000 with:

4 Docket Control
5 Arizona Corporation Commission
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9 mailed this 14th day of August, 2000 to:

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CITIZENS UTILITIES COMPANY
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DOCKET NOS. W-01032A-00-0192 ET AL.

SURREBUTTAL TESTIMONY

OF

GORDON FOX

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

SEPTEMBER 19, 2000

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Surrebuttal Testimony of Gordon L. Fox

Docket Nos. W-01032A-00-0192, W-01032B-00-0192, W-01032C-00-0192, S-02276A-00-0192, WS-02334A-00-0192, WS-03454A-00-0192, WS-03455A-00-0192, W-02013A-00-0192, W-01595A-00-0192, and W-01303A-00-0192
Sale of Assets and Transfer of CC&N (Citizens Communication, Inc. to Arizona-American Water Company)

1 **INTRODUCTION**

2 Q. Please state your name for the record.

3 A. My name is Gordon L. Fox.

4
5 Q. By whom are you employed?

6 A. The Residential Utility Consumer Office (RUCO) employs me in the
7 position of Utilities Chief Rate Analyst.

8
9 Q. Have you previously filed testimony in this docket?

10 A. Yes. I filed direct testimony in this docket on August 14, 2000.

11
12 Q. Have you identified any errors in you direct testimony that you want to
13 correct?

14 A. Yes. First, the discussion regarding accounting for an acquisition
15 adjustment on Page 14 of my direct testimony used the term "acquisition
16 adjustment" instead of the correct term, "Amortization of the Acquisition
17 Adjustment" on two occasions. I am providing a more complete
18 description of the accounting for an acquisition adjustment in my
19 surrebuttal testimony. Accordingly, I am withdrawing all of the testimony
20 on page 14 of my direct testimony. Second, the formula in condition 2 of
21 the criteria for determining the recoverable amount of the acquisition
22 premium presented on page 32, lines 11 – 13 was incorrect, the correct

Surrebuttal Testimony of Gordon L. Fox

Docket Nos. W-01032A-00-0192, W-01032B-00-0192, W-01032C-00-0192, S-02276A-00-0192, WS-02334A-00-0192, WS-03454A-00-0192, WS-03455A-00-0192, W-02013A-00-0192, W-01595A-00-0192, and W-01303A-00-0192
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1 formula follows: (Citizens 1999 Operating Expenses x (Test Year
2 Customers / 1999 Customers) – Test Year Operating Expenses) + (Test
3 Year Net Plant) x (1999 Cost Factor – Test Year Cost Factor). Third, I am
4 modifying my recommendation that as a condition for approval of this
5 transaction Az-Am invest in resource stressed utilities, to be applicable
6 only in the event that any of the other deficiencies I have identified are not
7 fully rectified. Finally, I have attached an errata sheet that identifies and
8 provides corrections for typographical and other minor errors.

9
10 Q. What is the purpose of your surrebuttal testimony?

11 A. The purpose of my surrebuttal testimony is to address arguments
12 presented in the rebuttal testimonies of the witnesses of the joint
13 applicants, Citizens' Communications, Inc. (formerly Citizens Utilities
14 Company, Inc.), ("Citizens") and Arizona-American Water Company,
15 (formerly Paradise Valley Water Company), ("Az-Am"). I explain why
16 certain comments or positions taken by the joint applicants are incorrect
17 and why the recommendations set forth in my direct testimony should be
18 adopted.

19
20 Q. What issues are you addressing in your surrebuttal testimony?

21 A. I am restricting the issues I am addressing to those that are most
22 significant as shown on the following list. Omission of a response to any

Surrebuttal Testimony of Gordon L. Fox

Docket Nos. W-01032A-00-0192, W-01032B-00-0192, W-01032C-00-0192, S-02276A-00-0192, WS-02334A-00-0192, WS-03454A-00-0192, WS-03455A-00-0192, W-02013A-00-0192, W-01595A-00-0192, and W-01303A-00-0192
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1 issue presented in the rebuttal testimonies of the witnesses of the joint
2 applicants is not an acceptance of their position. I have not changed my
3 position on any significant issue, as presented in my direct testimony,
4 except as specifically stated in my surrebuttal testimony.

5

- 6 • Sharing of the Gain
- 7 • Az-Am Investment in Resource Stressed Water and Wastewater Utilities
- 8 in Arizona
- 9 • Accounting Order Regarding the Method for Amortizing the Acquisition
- 10 Adjustment
- 11 • Advances-in-Aid-of-Construction and Contributions-in-Aid-of-Construction
- 12 • Low-cost Debt
- 13 • Criteria for Calculating the Recoverable Acquisition Adjustment

14

15 Q. How is the remainder of your testimony organized?

16 A. My surrebuttal testimony addresses issues presented in the rebuttal
17 testimonies of the joint applicants in the following sequence: Citizens'
18 witness, Mr. Carl W. Dabelstein; and Az-Am's witnesses, Mr. Daniel L.
19 Kelleher and Mr. David P. Stephenson.

20

21

SHARING OF THE GAIN

Q. Did you review Mr. Dabelstein's rebuttal position on behalf of Citizens regarding your recommendation to share the gain on the sale of assets equally between ratepayers and Citizens shareholders?

A. Yes. Mr. Dabelstein disagrees with my recommendation and advocates that ratepayers be excluded from sharing in any portion of the gain.

Q. Why do you believe Mr. Dabelstein has come to a different conclusion than you regarding whether ratepayers should share in the gain?

A. Mr. Dabelstein and I have a fundamental disagreement as to whether ratepayers share in risk for which they are entitled to compensation. As stated in my direct testimony, the parties that share in the risks related to utility assets should be entitled to share in the gain on the sale of those utility assets. Fairness dictates that if ratepayers share in the risks of assets used to provide public utility service, then ratepayers should reap a portion of any gain on the sale of those assets. Cash flows from the sale of assets are no less significant in the determination of fairness than the revenues generated by a utility's filed tariffs. There is no requirement that ratepayers must have taken an equity interest in assets to be entitled to a fair share of any gain resulting from the sale of those assets in which ratepayers have shared economic risk.

1 Q. On pages 9 and 10 of his rebuttal testimony, Mr. Dabelstein notes that
2 assets may be retired either after or before their expected average lives
3 and that rate base is preserved in both instances and that these
4 differences are expected to balance out over time. Does this in any way
5 refute your assertion that ratepayers share in the risk of assets used to
6 provide public utility service with the utility?

7 A. No. If the regulatory accounting for retirements did not preserve rate
8 base, the utility would absorb losses on premature retirements and retain
9 gains on late retirements. Preserving rate base on both premature and
10 late retirements reduces a utility's risk in two ways. First, the possibility
11 that the losses would exceed the gains over time is eliminated. Second,
12 mismatches in the timing between realization of gains and losses due to
13 retirements are eliminated, thus reducing the variability of the gains and
14 losses recognized in income among periods. Reducing the variability of
15 income and the associated risk is a direct result of transferring risk from
16 the utility to ratepayers. The elimination of both gains and losses on the
17 retirement of assets results in a sharing of risk. If ratepayers absorbed
18 only losses and utilities retained the gains on retirements of assets, then
19 ratepayers would be absorbing a disproportionate share of the risk. As
20 stated in my direct testimony, ratepayers participate in the risks of assets
21 used to provide public utility service; they do not shoulder all of the risks.
22

1 Q. The proposed sale of assets, as note by Mr. Dabelstein (page 9), is not a
2 retirement in the traditional sense. Does the characterization of the
3 transaction as a retirement or a sale have any relevance to whether the
4 gain on the sale should be shared between ratepayers and stockholders?

5 A. No. The relevant issue is whether ratepayers have shared in the risk of
6 the assets. My purpose for explaining the normal accounting treatment for
7 retirements, as presented on page 10 of my direct testimony, was to show
8 that ratepayers share in the risks of utility assets. Since ratepayers share
9 in the risks of utility assets, to be fair, they should also share in any gain
10 related to the sale of those assets. Ratepayers are continuously exposed
11 to risk related to utility assets. There is no basis for limiting ratepayers'
12 participation in gains to any particular type of transaction. Failure to allow
13 ratepayers to share in the gain on the sale of assets denies them of their
14 due compensatory rewards for the risks they have shared.

15
16 Q. Are the distinctions that Mr. Dabelstein claims on page 3 of his rebuttal
17 testimony between the circumstances in the current case and those from
18 previous cases where the Commission has ordered a sharing of the gains
19 on the sales of assets germane to whether sharing is appropriate in the
20 current case?

21 A. No. Whether the assets to be sold continue to be used for public service
22 after the sale or whether a single asset or all of the utility assets are sold

1 should have no bearing on whether ratepayers are entitled to share in the
2 gain. These factors do not change the fact that ratepayers have shared in
3 the risk of these assets during the period of their appreciation in value.
4 Ratepayers will be denied fair treatment if they have shared risk related to
5 these assets and do not participate in the gain. Contrary to Mr.
6 Dabelstein's assertion on page 7 that, "... customers should be indifferent
7 because the same assets will be used to provide service after the sale as
8 before," ratepayers will be affected by the transaction. For example, Mr.
9 Dabelstein states (page 7), "... gains associated with utility asset sales
10 typically reflect intangible values associated with the selling company's
11 operations." Generally, the most significant intangible asset related to a
12 transaction is goodwill. Goodwill represents the present value of cash
13 flows in excess of book value that the acquiring entity expects to generate
14 from the assets. Ratepayers will not benefit from any increase in value
15 because ratepayers are the source of cash flows to the utility. Thus, if
16 ratepayers are to share in any increase in the value of the assets in which
17 they have shared risk, ratepayers must receive a portion of the gain.
18 Otherwise, the selling entity will reap all of the gain and ratepayers will
19 have incurred risk with no reward.

AZ-AM INVESTMENT IN RESOURCE STRESSED UTILITIES

Q. Did you review the rebuttal position of Az-Am's witness, Mr. Daniel L. Kelleher, regarding your recommendation that "authorization of the transaction be made contingent upon Az-Am's Board of Directors approving a letter pledging to invest not less than 15 percent of the purchase price in this transaction in acquisitions and capital improvements of "resource stressed" water and wastewater utilities in Arizona no later than 72 months after the date this transaction is authorized by the Commission"?

A. Yes. Mr. Kelleher advocates that the Commission reject my recommendation. My interpretation of Mr. Kelleher's testimony is that he claims my recommendation has the following deficiencies: (1) fails to clearly define the eligible investments; (2) fails to explain the regulatory treatment for the investments (3) imposes a \$35 million penalty on Az-Am; (4) creates substantial disincentives for the provision of assistance to, or the acquisition of, small, troubled water systems; (5) is detrimental to the transaction in this proceeding; (6) is lacking sufficient implementation details; and (7) is not supported by legal authority.

Q. Should Az-Am have any difficulty identifying the eligible investments?

A. I would think not. As stated above, the eligible investments are acquisitions and capital improvements. Az-Am should recognize the term

1 capital improvements as expenditures that would be capitalized under the
2 National Association of Regulatory Utility Commissioners (NARUC)
3 Uniform System of Accounts (USOA). Purchase price represents
4 acquisition amounts. Eligible acquisitions were described in my direct
5 testimony (page 34, lines 7 – 9), as “Class “C,” “D,” and “E” water and
6 wastewater utilities regulated by the Commission whose stock or whose
7 affiliates’ stock is not regularly traded on a major stock exchange and any
8 utility approved by the Director of the Utilities Division.” In response to Az-
9 Am data request 1.37, RUCO referred Az-Am to the Commission Staff for
10 additional information. The Commission maintains various records and
11 data bases with information that would assist Az-Am in identifying
12 qualifying acquisition targets. The annual reports utilities are required to
13 file are readily available at the Commission and provide essentially all the
14 information (company name, mailing address, contact names and
15 telephone numbers, type of utility, counties served, form of organization,
16 annual revenues, parent company, plant values, statistical operating
17 information, etc.) Az-Am may need to begin identifying eligible
18 acquisitions. As a long-time operator of a utility in Arizona that files its
19 own annual report, Az-Am, should have knowledge of the information
20 available from this source. Also, Az-Am, is a subsidiary of American
21 Water Works Company, Inc. (AWW), the nation’s largest investor-owned
22 water utility company. According to AWW’s 1999 annual report to

1 shareholders, AWW began its largest acquisition program in the
2 company's history in 1999. AWW's acquisition program includes the
3 \$231.3 million acquisition of Citizens assets in Arizona and in all
4 probability included analysis of other investment opportunities in Arizona.

5

6 Q. Please comment on Mr. Kelleher's concern that you have not
7 recommended the regulatory treatment to be applied to the investments.

8 A. Mr. Kelleher has not explained what regulatory treatments he feels need
9 addressing. It is only prudent for the Commission to examine the
10 circumstances of each transaction and apply its discretion to provide a fair
11 and reasonable outcome. At this time there is no basis for a ruling on any
12 rate-making treatment.

13

14 Q. Please comment on Mr. Kelleher's assertions that requiring Az-Am to
15 invest in resource stressed utilities imposes a monetary penalty and
16 creates disincentives for acquiring and assisting trouble utilities.

17 A. Mr. Kelleher has provided no basis for these assertions. My
18 recommendation is for Az-Am to make an investment in resource stressed
19 utilities. Az-Am should be provided the same opportunity to generate
20 sufficient revenues to recover this investment and to earn a return on this
21 investment as is appropriate for any other investment in public service
22 utilities in Arizona. My recommendation in no manner suggests that Az-

1 Am is to be penalized, required to make a contribution, or to be subjected
2 to any other financial hardship. To the contrary, if the initial investments
3 are fruitful, Az-Am and other utilities will be encouraged to make additional
4 investments in resource stressed utilities. The term resource stressed, as
5 I have applied it to utilities, should not be construed as synonymous with
6 unprofitable. Resource stressed utilities often are lacking in one or more
7 of the essential qualities (technological, managerial, operational, and
8 financial) needed to provide sufficient and adequate service.

9
10 Q. Is your recommendation to require Az-Am to acquire resource stressed
11 utilities a potential detriment to the transaction in this proceeding?

12 A. Depending on other considerations, my recommendation could either be
13 an essential component of this transaction or, unless slightly modified, a
14 detriment to this transaction. As identified on page 28 of my direct
15 testimony, my analysis shows that several aspects of this transaction, as
16 proposed, will have a substantial detrimental economic effect on
17 ratepayers. If all of my recommendations pertaining to those items are
18 adopted, I could recommend approval of the transaction in the absence of
19 any further investments by Az-Am. However, I recognized that completely
20 rectifying these items would be difficult. Assuming the detrimental impact
21 of these items could be largely, but not completely, remedied, I
22 recommended that Az-Am make investments in resource stressed utilities

1 to provide a "bridge" that would make this transaction in the public interest.
2 Accordingly, I am modifying my recommendation regarding Az-Am's
3 investment in resource stressed utilities, to be applicable only in the event
4 that any of the other deficiencies I have identified are not fully rectified.

5

6 Q. Please comment on Mr. Kelleher's concern regarding a lack of
7 administrative details for implementing Az-Am's investment in resource
8 restricted utilities.

9 A. I see no reason for imposing any particular administrative requirement on
10 Az-Am pertaining to these investments other than for Az-Am to provide the
11 Commission with documentation supporting compliance with the amount
12 and timing of its investments pursuant to the Commission's decision.

13

14 Q. Please comment on Mr. Kelleher's concern that you have not addressed
15 the legal authority for your recommendation regarding Az-Am's investment
16 in resource restricted utilities.

17 A. To the extent it involves rate-making, the Commission may use discretion
18 in its decisions with a focus on results that are fair and equitable. As I
19 discussed previously in this testimony, my recommendation regarding Az-
20 Am's investment in resource stressed utilities is a creative solution to
21 overcome other shortcomings in the transaction, as proposed in the joint
22 application, that were detrimental to ratepayers. I believe Az-Am's

1 acquisition of resource stressed utilities can be a benefit to the public.
2 Provided that the shortcomings of the application can be otherwise largely
3 overcome, the benefit to the public from Az-Am's investment in resource
4 stressed utilities may be sufficient to create a transaction that is equitable
5 overall. Stated differently, if the shortcomings of the transaction, as
6 proposed in the joint application, cannot be fully overcome, or substantially
7 overcome and Az-Am is not willing to make a commitment to invest in
8 resource stressed Arizona utilities, the transaction is not in the public
9 interest.

10
11 Q. Do you have any further comments pertaining to Mr. Kelleher's rebuttal
12 testimony and your recommendation for Az-Am to make additional
13 investments in Arizona's resource stressed utilities?

14 A. Yes. Mr. Kelleher has made a number of comments in his direct and
15 rebuttal testimonies: (1) professing a willingness to assist in the resolution
16 of water and wastewater problems, (2) noting that acquisitions and
17 consolidations are a part of AWW's strategic goals; (3) claiming that this
18 transaction will better position Az-Am to accelerate and expand the
19 acquisition of and assistance provided to small, nonviable Arizona water
20 and wastewater systems; and (4) declaring that Az-Am recognizes a
21 responsibility to assist in the resolution of structural problems plaguing the
22 water industry which impede achievement of safe and reliable service to

1 all consumers in Arizona. Despite these comments, Az-Am is now balking
2 and attempting to completely dismiss my recommendation that it be
3 required to take action that is consistent with these testimonials.

4

5 **ACCOUNTING ORDER – METHOD FOR AMORTIZING THE ACQUISITION**
6 **ADJUSTMENT**

7 Q. Did you review Mr. Stephenson's rebuttal position on behalf of Az-Am
8 regarding the Company's request for an accounting order authorizing use
9 of a specific amortization method and period?

10 A. Yes. My understanding of Mr. Stephenson's rebuttal testimony is that Az-
11 Am is not withdrawing its request for approval of the mortgage
12 amortization method for amortizing the acquisition adjustment but is now
13 proposing to defer a determination on the method and period for
14 amortizing the acquisition adjustment to the next general rate case.

15

16 Q. Do you agree that the Commission should defer a decision on the method
17 and period for amortizing the acquisition adjustment to the next rate case?

18 A. Yes. I also agree that Az-Am has the right to request any amortization
19 method and period it deems appropriate in the next rate case. However, I
20 believe the Commission should evaluate whether procedurally the current
21 request should remain outstanding until that time, as proposed by Az-Am.
22 I should also explain that I am using the term "acquisition adjustment" to

1 refer to the amount, if any, of a regulatory asset that the Commission may
2 allow for recovery in the next rate case that pertains to the transaction that
3 is the subject of this proceeding. I should also note that I made similar
4 use of this term in my direct testimony.

5

6 Q. Can you explain why you are making this distinction?

7 A. The amortization of the acquisition adjustment as defined by the USOA
8 and the regulatory asset to be recovered from ratepayers via rates may be
9 separate amounts, and depending on the circumstances, may be
10 amortized over different periods. The Commission's decision regarding
11 the amount of the regulatory asset and the method and period for recovery
12 via rates is not affected by the manner in which Az-Am accounts for the
13 acquisition adjustment for external reporting purposes. However, the
14 Commission's decision on the rate-making treatment can affect Az-Am's
15 external accounting for the acquisition adjustment. The distinction is
16 relevant for purposes of showing that an accounting order is not
17 appropriate in this proceeding and should be deferred to the next general
18 rate case. Since Az-Am is agreeing to defer its request for an accounting
19 order until the next rate case, the distinction is no longer significant in this
20 proceeding.

21

Surrebuttal Testimony of Gordon L. Fox

Docket Nos. W-01032A-00-0192, W-01032B-00-0192, W-01032C-00-0192, S-02276A-00-0192, WS-02334A-00-0192, WS-03454A-00-0192, WS-03455A-00-0192, W-02013A-00-0192, W-01595A-00-0192, and W-01303A-00-0192
Sale of Assets and Transfer of CC&N (Citizens Communication, Inc. to Arizona-American Water Company)

1 Notwithstanding the continuing relevance to this proceeding, as I
2 discussed previously in this testimony, due to errors on page 14 of my
3 direct testimony, I am providing a more complete description of the
4 accounting for an acquisition adjustment.

5

6 Q. Mr. Fox, can you provide an explanation of the accounting principles that
7 apply to an acquisition adjustment?

8 A. Yes. I'll begin by providing the authoritative basis for accounting principles
9 in the U.S. The Securities and Exchange Commission (SEC), a federal
10 government agency established by the U.S. Congress, has the statutory
11 authority to establish accounting practices. This authority has been
12 primarily delegated to the American Institute of Certified Public
13 Accountants (AICPA), an organization of Certified Public Accountants. In
14 1973, the AICPA established the seven-member Financial Accounting
15 Standards Board (FASB) for the purpose of establishing standards for
16 financial accounting and reporting that apply to all non-governmental
17 entities. The FASB uses Statements of Financial Accounting Standards
18 (SFAS) as the primary method of establishing accounting standards.
19 Authoritative pronouncements of the Accounting Principles Board (APB)
20 and the Committee on Accounting Procedure that preceded FASB that
21 have not been superseded by a new FASB standard are also considered
22 generally accepted accounting standards (GAAP). Use of standard

1 accounting principles is necessary to make financial reports meaningful
2 and useful to users. The underlying standard for presenting external
3 financial statements in accordance with GAAP is to have no material
4 (significant) misstatement. That is, any misstatement shall not be
5 significant enough to cause a user to make an alternate decision due to
6 the misstatement.

7
8 The primary accounting principles that apply to an acquisition adjustment
9 are SFAS No. 71 "Accounting for the Effects of Certain Types of
10 Regulation" ("SFAS 71") and APB No. 17 "Intangible Assets" ("APB 17").
11 According to SFAS 71 an acquisition adjustment is the value in excess of
12 book value of identifiable assets obtained, valuation adjustments
13 applicable to liabilities assumed, or goodwill or a combination of those
14 items. APB 17 requires intangibles, e.g. goodwill or acquisition
15 adjustments, to be amortized by systematic charges to income over the
16 periods to be benefited. APB identifies some of the factors to be
17 considered in determining the amortization period and states, "[T]he
18 period of amortization of intangible assets should be determined from the
19 pertinent factors." Regulation is one of the pertinent factors listed and
20 particularly relevant to an acquisition adjustment of a regulated utility. The
21 allowable range for the amortization period is forty years or less. APB 17
22 further requires use of the straight-line amortization method unless a

1 company demonstrates that another systematic method is more
2 appropriate. APB 17 also requires a company to, "[e]valuate the periods
3 of amortization continually to determine whether later events and
4 circumstances warrant revised estimates of useful lives." SFAS 71 states,
5 "[I]f there is no indication that the amortization will be allowed in a
6 subsequent period, the goodwill would be amortized for financial reporting
7 purposes and continually evaluated to determine whether the unamortized
8 cost should be reduced significantly by a charge to income [written off]."
9 Under the provisions of SFAS 71 if the Commission allows recovery via
10 rates of the amortization of the acquisition adjustment over a specific time
11 period, a regulatory asset is created and the acquisition adjustment is
12 amortized for external financial reporting purposes over the same time
13 period as allowed for rate-making purposes.

14
15 Q. Please explain how these accounting principles apply to Az-Am's
16 acquisition adjustment in this transaction.

17 A. If the Commission establishes an amount of the acquisition adjustment for
18 recovery via rates over a specific time period in this case, Az-Am will
19 recognize the same amount of amortization of the acquisition adjustment
20 for rate-making and for external financial statement reporting in each
21 period as designated by the Commission. If the Commission does not
22 establish an amount and time period for recovery of an acquisition

1 adjustment in this case, Az-Am must begin amortizing the acquisition
2 adjustment at the transaction date in accordance with the accounting
3 principles established in APB 17. That is, Az-Am will begin amortizing the
4 acquisition adjustment over a period not to exceed 40 years based upon
5 management's determination of the period that this intangible asset will
6 provide benefits. The straight-line method will be required to amortize the
7 acquisition adjustment unless Az-Am can demonstrate that another
8 method is more appropriate. When the Commission makes a
9 determination of the amount and time period for recovery, e.g., in a future
10 rate case, Az-Am will be required to adjust the balance of the acquisition
11 adjustment, the periodic amortization amount and method to conform to
12 the Commission's decision. That is, Az-Am must revise the acquisition
13 adjustment balance, amortization time period and method to reflect the
14 subsequent event (e.g., a Commission decision). The accounting for
15 external reporting will also be subject to all other applicable GAAP, e.g.,
16 recognition of insignificant amounts is not required.

17
18 Q. What would be the affect of the Commission granting Az-Am's request for
19 an accounting order authorizing use of the mortgage amortization method
20 of amortizing the acquisition adjustment?

21 A. The purpose an accounting order is to allow a utility to present its external
22 financial statements in a manner that would not conform to GAAP absent

1 the accounting order. An accounting order does not place constraints on
2 the Commission's rate-making treatment. An accounting order can help a
3 utility reflect more accurately in its financial statements the special
4 circumstances of a regulated public service corporation.

5
6 If the Commission authorizes Az-Am to use the mortgage amortization
7 method, Az-Am will amortize whatever amount of the acquisition
8 adjustment that is authorized by the Commission for recovery via rates
9 using the mortgage amortization method over the authorized time period
10 for rate-making and for external financial statement reporting purposes. In
11 addition, Az-Am's external financial statements must recognize
12 amortization or write-off of any amount of the acquisition adjustment that is
13 not authorized for recovery via rates. The proper accounting treatment for
14 the portion of the acquisition adjustment that is not recovered via rates is
15 subject to APB 17 guidelines, i.e., "[e]valuate the periods of amortization
16 continually to determine whether later events and circumstances warrant
17 revised estimates of useful lives" and "[E]stimation of the value and future
18 benefits of an intangible asset may indicate that the unamortized cost
19 should be reduced significantly by a deduction in determining net income."

20
21 Thus, the requested accounting order, if authorized, would only serve to
22 establish the amortization method and number of years that would be

1 used to amortize the amount, if any, of the acquisition adjustment the
2 Commission allows for recovery in rates. Since Az-Am is also requesting
3 that the Commission defer until its next general rate case a determination
4 of the amount of the acquisition adjustment for recovery, authorization of
5 the accounting order in this proceeding would only provide Az-Am with the
6 method and term of the amortization period that will become effective in
7 conjunction with a Commission order in Az-Am's next rate case. This
8 advance determination of the amortization method and term will have no
9 impact on Az-Am's external financial statements in the interim periods. If
10 the Commission ultimately decides to grant authorization of the requested
11 accounting order, the granting of such request would be of equal benefit to
12 Az-Am if granted in conjunction with Az-Am's next rate case. At that time
13 the Commission could also consider the amount, if any, of the acquisition
14 that is to be recovered via rates and other results of the rate case to
15 enhance the information available for either authorizing or denying Az-
16 Am's accounting order request.

**ADVANCES-IN-AID-OF-CONSTRUCTION AND CONTRIBUTIONS-IN-AID-OF-
CONSTRUCTION**

Q. Did you review Mr. Stephenson's rebuttal position on behalf of Az-Am regarding the treatment of advances-in-aid-of-construction (AIAC) and contributions-in-aid-of-construction (CIAC)?

A. Yes. Mr. Stephenson states his disagreement (pp. 5 and 6) with my recommendation that ratepayers be fully compensated for the loss of advances and contributions. Mr. Stephenson (page 3, line 5) also states, "I do not believe that the Commission should impute Citizens' advances and contributions to Arizona-American . . ." as recommended by the Commission Staff. Mr. Stephenson further asserts that if the Commission were to adopt Staff's recommendation to impute AIAC the amortization period should be 6.5 years instead of 10 years as proposed by Staff. According to Mr. Stephenson, Staff is proposing to amortize CIAC over the assets useful lives, however, he sees no reason not to use the same 6.5 year amortization period he would consider for amortizing AIAC.

Q. How would amortization of AIAC over 6.5 years, as suggested by Az-Am, or 10 years, as recommended by Staff, compare to the normal treatment of AIAC?

A. Amortization of AIAC is not the normal treatment of AIAC, and ratepayers are likely to be harmed by the amortization of AIAC regardless of whether

1 the amortization period is 6.5 or 10 years as compared to the normal AIAC
2 treatment. Normally the balance of AIAC is reduced by the amount of
3 refunds made. Advance agreements normally provide for annual refunds
4 equal to ten percent of the revenues generated during the year from the
5 plant constructed with the advanced funds for ten years. Ten percent of
6 revenues is different from ten percent of the advanced amount.
7 Frequently, the total refunds over the ten-year period of the advance
8 agreement will be less than the original amount of the advance. When
9 this occurs, the remaining AIAC balance is converted to CIAC. In
10 accordance with the treatment specified in the NARUC USOA, the
11 amortization of CIAC is treated as a reduction to Depreciation Expense.
12 That is, the amortization of CIAC is a reduction to operating expense
13 (recognized above the line) and reduces the revenue requirement. The
14 proposed imputation of an AIAC balance based on an amortization period
15 as recommended by Staff and suggested by Az-Am will deprive
16 ratepayers of the above the line recognition of CIAC amortizations
17 resulting from AIAC conversions.

18
19 Q. How could this deficiency be corrected?

20 A. Citizens' AIAC balance could be carried-forward or imputed. Az-Am will
21 have the records necessary to identify the refunds that should be payable.
22 This information could be used to identify the AIAC balance and the CIAC

1 conversions that would have existed had Citizens not sold the assets to
2 Az-Am. The AIAC and CIAC balances and the CIAC amortizations could
3 be imputed in future Az-Am rate cases based on these records. This
4 treatment places ratepayers in the same position that would have existed
5 had the transaction not occurred. As a simple, but less accurate
6 alternative, AIAC could be imputed in future rate cases as recommended
7 by Staff, but the amortization period should be extended sufficiently to
8 compensate for the loss of the above the line amortizations of any CIAC
9 benefits foregone by ratepayers.

10
11 Q. You mentioned that the NARUC USOA specifies that the amortization of
12 CIAC will be recognized as a reduction to Depreciation Expense and
13 result in a reduction of the revenue requirement. Is this consistent with the
14 recommended treatment by Staff and the suggested treatment by Az-Am?

15 A. Az-Am does not address this issue specifically. Ms. Jaress, on behalf of
16 Staff states (pp. 9 and 19), "[T]he imputation to recognize the foregone
17 contributions should be reduced by the below-the-line amortization of the
18 contributions which would have otherwise occurred." The intent of this
19 statement is unclear, however, the accepted rate-making and accounting
20 treatment for the amortization of CIAC is as an above-the-line
21 amortization, i.e., as a reduction to operating expense.

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1 Q. Mr. Stephenson's rebuttal testimony takes exception to a number of
2 specific components of your direct testimony regarding AIAC and CIAC.
3 Do you agree with any of his comments?

4 A. Yes. Mr. Stephenson correctly notes (p. 12) that my calculation of the
5 \$10.4 million revenue impact related to the elimination of AIAC and CIAC
6 is based on unsupported assumptions for a four percent depreciation rate
7 and a revenue conversion factor of 1.5. In addition, he stated the need to
8 gross-up the deferred income taxes.

9
10 Q. What is the impact of these three items on your \$10.4 million estimate of
11 the incremental revenue requirement due to the elimination of AIAC and
12 CIAC?

13 A. There is no significant impact. My direct testimony clearly states that I
14 used estimates for the depreciation rate and revenue conversion factor.
15 The purpose of my calculation is to show a reasonable estimate of the
16 consequences to the revenue requirement of removing AIAC and CIAC
17 from rate base. A revenue conversion factor of 1.5 is applicable to a
18 taxable income of approximately \$159,000. This revenue conversion
19 factor of 1.5 provides a conservative (low) estimate for the overall tax and
20 revenue consequences relating to the elimination of AIAC and CIAC for
21 the properties that are the subject of this transaction (Staff used a revenue
22 conversion factor of 1.6 to estimate an impact of \$12.8 million). Mr.

1 Stephenson believes my use of a four percent depreciation rate overstates
2 the revenue requirement impact. However, if I were to assume a three
3 percent depreciation rate and recognize a gross-up for the deferred
4 income taxes the result is a reduction of the estimated incremental
5 revenue requirement due to the elimination of AIAC and CIAC from \$10.4
6 million to \$10.0 million $[(\$85.6 \text{ million AIAC \& CIAC} - \$6.7 \text{ million ADIT}) \times$
7 $0.0855 \text{ cost of capital} \times 1.5 \text{ revenue conversion factor}) - (\4.7 million
8 $\text{CIAC} \times 0.03 \text{ depreciation rate})]$, an insignificant difference for this
9 purpose.

10
11 Q. Please address the remainder of Mr. Stephenson's rebuttal testimony
12 regarding your recommendation that ratepayers should be compensated
13 for the loss in economic value due to the loss of AIAC and CIAC resulting
14 from the transaction.

15 A. Mr. Stephenson has expounded extensively on this issue with inaccurate
16 statements, misapplied logic, legal interpretations, assertions and
17 misinterpretations of my testimony, and erroneous conclusions. I will
18 briefly address these diversions after refocusing on the primary issue on
19 this topic. The primary issue is that elimination of AIAC and CIAC will
20 essentially double the rate base and increase the revenue requirement by
21 approximately one-third. This large increase in the revenue requirement is
22 unlikely to be overcome by any synergy savings achieved by Az-Am and

1 such a large increase in the revenue requirement is a significant
2 consideration as to whether the proposed transaction is in the public
3 interest.

4
5 Mr. Stephenson (p. 8) suggests that the Commission is limited to
6 considering only those factors that would serve to impair the ability to
7 provide service in determining whether the transaction is in the public
8 interest. Specifically, he calls "erroneous" my conclusion that the
9 Commission can consider an increase in rate base and the upward
10 influence that it causes on future rates in its determination because I made
11 no authoritative cite in my testimony or in data responses for the
12 Commission to make such consideration. In response to Az-Am data
13 request 1.35, RUCO provided Az-Am with references to ARS §40-285 and
14 Pueblo Del Sol Water Co. v. Arizona Corp. Commission, 160 Ariz. 285,
15 772 P.2d 1138 (App. 1988). Regardless, the Commission's powers are
16 not limited based on the inclusion or omission of authoritative cites in my
17 testimony. With the exception of unlawful, unreasonable or arbitrary
18 decision-making, I am not aware of any limitations placed on the
19 Commission that would serve to limit the factors the Commission may
20 consider in determining whether the transaction is in the public interest.
21 The magnitude of the impact on rates of eliminating AIAC and CIAC will
22 certainly be of interest to the public.

1 Mr. Stephenson's rebuttal (p. 9) asserts that "Mr. Fox accuses Arizona-
2 American of deliberately structuring the transaction to eliminate advances,
3 increase rate base, and increase rates, thereby causing customers to
4 subsidize "non-economic development" and to "pay twice" for plant
5 financed by advances." Mr. Stephenson has misinterpreted my testimony.
6 I have not suggested that the negative consequences of the transaction,
7 as proposed in the joint application, resulted from Az-Am conspiring
8 against ratepayers. I have used the terms "structure" and "restructure" in
9 a broad sense to refer to various terms of the Asset Purchase Agreement.

10
11 Regarding Mr. Stephenson's rebuttal comments (pp. 9-11) as to whether
12 elimination of AIAC will cause certain ratepayers to pay twice for a portion
13 of the cost of plant extended to their area, I have the following comments.
14 First, a developer is the original homeowner. A developer's sale of a
15 home is no different than subsequent sales in terms of whether a
16 homeowner has paid for plant via an advance. If the developer has paid
17 for the plant once and Az-Am recovers the cost again via a return on and
18 a return of the plant purchased with advanced funds, then, a
19 homeowner/ratepayer has paid twice for the plant. Second, my
20 interpretation of Mr. Stevenson's rebuttal is that he believes ratepayers
21 are compensated for their advance payments by the appreciation in the
22 value of their homes by way of having access to utility service. Any

1 appreciation in the value of homes has no bearing on the treatment of
2 AIAC. A ratepayer's home value is not dependent upon the number of
3 times ratepayers pay a utility for providing service to the home. That is, a
4 home does not appreciate each time the cost of the main extension is paid
5 for by homeowners. Any appreciation in home value due to a home
6 having access to utilities is not justification for eliminating AIAC. If this
7 were true, elimination of AIAC would be a regular practice. Third, Mr.
8 Stevenson seems to be implying that RUCO's purpose for recommending
9 that ratepayers be compensated for the loss of AIAC is to penalize Az-Am
10 by reducing its rate base, or the investment upon which Az-Am will earn
11 future returns. This is a misconception. RUCO is not intent on penalizing
12 Az-Am. However, the reality is that elimination of AIAC will have a
13 substantial negative impact on rates. Ratepayers should not have to
14 absorb this economic loss simply because of a change in the ownership of
15 the assets. The economic consequences (incremental cost) to ratepayers
16 of eliminating AIAC is a consideration in the determination of whether the
17 transaction is in the public interest. In the absence of ratepayers being
18 compensated for the loss of AIAC, RUCO believes this transaction is not
19 in the public interest. If it is also true, that the transaction cannot be
20 modified in such a manner that ratepayers can be compensated and Az-
21 Am can earn a fair return, then the viability of this transaction is in
22 question.

1 On page 3, in response to Ms. Jaress, and on page 7, in response to my
2 testimony, Mr. Stephenson's rebuttal suggests that this transaction was
3 bargained for at arm's-length and that Az-Am should be entitled to earn a
4 fair return on the \$230 million purchase price. One of the objectives of
5 regulation is to act as a surrogate for competition. Non-regulated
6 Companies also engage in sale-of-business transactions. These
7 transactions do not occur with the relative efficiency that individual shares
8 of stock trade in major stock markets where there are many thousands of
9 buyers and sellers. In sale-of-business transactions there is only one
10 seller and a handful of potential buyers. This type of transaction is
11 essentially an auction to the highest bidder. There is no assurance that
12 the highest bid is reasonable.

13
14 The fact that two non-regulated entities agree to a price in an arm's-length
15 transaction is no guarantee that the price paid was reasonable or that the
16 acquiring entity will be able to recover the purchase price. If the acquiring
17 entity increases prices to customers above that of the selling entities
18 former prices, in a competitive industry customers have the choice of
19 taking their business elsewhere. The acquiring entity may not be able to
20 recover its acquisition price and may even become insolvent.

1 Unlike the customers in a competitive industry, utility ratepayers are
2 captive customers; they have no alternative service choices. If the
3 regulatory process works properly, the regulator will not approve proposed
4 utility transactions that are economically unsound. An economic failure by
5 the acquiring utility is likely to have undesirable consequences on service.
6 In the event of economic failure, ratepayers will ultimately pay higher rates
7 to "bail out" the failed utility. Alternately, so that such economic failure
8 does not occur, ratepayers may be forced to pay higher rates to provide
9 the acquiring utility a return that could not be obtained in a competitive
10 industry.

11
12 Simply because Az-Am acquired Citizens' Arizona water and wastewater
13 properties via an arm's-length negotiation is no assurance that the price is
14 reasonable nor is it justification for a full recovery from captive ratepayers.
15 Further, the application and testimonies on behalf of Az-Am show that Az-
16 Am expects to recover the full purchase price of the Citizens' water and
17 wastewater properties and that Az-Am believes that the associated
18 negative impact on rates should not be a consideration in determining
19 whether this transaction is in the public interest. If acquiring utilities can
20 pass-through to ratepayers the purchase price without justification of its
21 upward effect on rates, acquiring utilities will have no incentive to

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1 negotiate in good faith. Such a regulatory policy is not in the public
2 interest.

3
4 Mr. Stephenson's rebuttal comment (page 7) asserts that I did not
5 consider the impact of the repayment stream for the advances that would
6 have occurred had Az-Am assumed the AIAC. The \$10.0 million impact
7 on revenue as calculated previously due to the elimination of AIAC and
8 CIAC pertains to the outstanding AIAC and CIAC balances at December
9 31, 1999. To project the revenue effect on future years requires making
10 assumptions for each of the parameters (AIAC balance, CIAC balance,
11 ADIT balance, cost of capital, revenue conversion factor, and depreciation
12 rate) in the equation. A reasonable estimate can be obtained by keeping
13 all factors the same as in the \$10.0 million calculation except for the AIAC
14 balance. Calculating the revenue impact in this manner, assuming that
15 the 6.5-year amortization period suggested by Mr. Stephenson is
16 reasonable, provides the following results (rounded to the nearest million):

17
18 Year 2000 \$10 million
19 Year 2001 \$ 8 million
20 Year 2002 \$ 7 million
21 Year 2003 \$ 5 million
22 Year 2004 \$ 3 million
23 Year 2005 \$ 2 million
24 Year 2006 \$ 0 million
25 Total \$40 million
26

1 A longer and more appropriate, as previously discussed, amortization
2 period would show an overall increase in revenue due to the elimination of
3 AIAC and CIAC exceeding \$40 million.

4

5 **LOW-COST DEBT (INDUSTRIAL DEVELOPMENT REVENUE BONDS)**

6 Q. Did you review Mr. Stephenson's rebuttal position on behalf of Az-Am
7 regarding that Citizens' retention of certain Industrial Development
8 Revenue Bonds (IDRB)?

9 A. Yes. Mr. Stephenson claims that my conclusion that Citizens' retention of
10 certain IDRBs will result in a loss of economic value to ratepayers is
11 illogical because Az-Am will finance the entire transaction with the lowest
12 cost of capital available. If Az-Am had demonstrated that its cost of debt,
13 equity and overall cost of capital are less than Citizens', Mr. Stephenson
14 would have a point. However, Az-Am has not made any such
15 demonstration. Assuming that the capital structure will continue to contain
16 similar proportions of debt and equity, if Az-Am's cost of debt is greater
17 than Citizens' IDRBs, Az-Am's non-assumption of certain IDRBs will have
18 an upward influence on the cost of capital and rates in future rate cases.
19 Mr. Stephenson also notes that administratively it would be difficult to
20 assume Citizens' IDRBs. Regardless of the administrative burdens that
21 would be endured for Az-Am to acquire these IDRBs, this portion of the
22 transaction places upward pressure on rates and, accordingly, is a

1 negative factor in evaluating whether the transaction, as proposed, is in
2 the public interest.

3

4 **CRITERIA FOR CALCULATING THE RECOVERABLE ACQUISITION**

5 **ADJUSTMENT**

6 Q. Did you review Mr. Stephenson's rebuttal position on behalf of Az-Am
7 regarding the formula you recommended for determining the amount of
8 the acquisition adjustment that is recoverable in rates?

9 A. Yes. Mr. Stephenson's testimony expressed the following concerns
10 regarding my recommended formula: (1) fifty percent of the result would
11 be shared with ratepayers; (2) changes in the cost of capital and cost of
12 construction are not recognized; (3) fails to recognize refunds of advances
13 to be made by Citizens; and (4) fails to consider inflation and mandated
14 changes in operations.

15

16 Q. Please comment on these criticisms.

17 A. The task of determining an appropriate amount of the acquisition
18 adjustment that Az-Am can justifiably recover from ratepayers is one for
19 which there is no ideal method. Any method selected will have limitations.
20 I recognized these limitations in developing the recommended formula.
21 The purpose of the recommended formula and criteria is to establish a
22 reasonably simple and objective method for recognizing the amount of the

1 acquisition adjustment that may be recoverable in rates. Mr. Stephenson
2 is correct that the formula does not consider inflation, changes in the cost
3 of capital, changes in the cost of construction, or required changes in
4 operations, all of which are reasonable goals. These are also difficult or
5 impossible to reliably measure. These and other trade-offs are acceptable
6 in exchange for a formula that provides a relatively simple and measurable
7 result. Also, the criteria for implementing the formula provide Az-Am with
8 compensating benefits such as a choice of test year, use of unaudited
9 1999 expenses as the standard for comparison, and no productivity factor
10 offset. It also provides definitive criteria upon which Az-Am can rely
11 regarding the future regulatory treatment and recoverability of the
12 acquisition adjustment that also protects the interests of ratepayers.

13
14 Appropriately, the formula, by design, does not recognize Citizens' refunds
15 of advances. The purpose of the formula is the share the benefits of
16 synergies that will affect rates. Az-Am's revenue requirement and the
17 associated rates will not be affected by Citizens' refunding on advances.

18
19 Mr. Stephenson's concern that ratepayers may benefit from the
20 transaction speaks for itself. Ratepayers are at risk if Az-Am fails to
21 provide synergies that result in an overall net benefit to ratepayers. For
22 example, if Az-Am operating costs are greater than Citizens would have

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1 been, Az-Am will still expect to recover all of its operating costs, not just
2 the level of operating costs that Citizens would have incurred. The
3 formula does not limit the recoverable acquisition adjustment to the actual
4 excess on purchase price over book value. Az-Am and ratepayers will
5 share in each incremental improvement captured by the formula.

6

7 Q. Do you have any other comments on the formula?

8 A. Yes. As stated in RUCO's response to Az-Am's data request 1.39, the
9 formula as stated in my direct testimony is in error. The correct formula is:
10 (Citizens 1999 Operating Expenses x (Test Year Customers / 1999
11 Customers) – Test Year Operating Expenses) + (Test Year Net Plant) x
12 (1999 Cost Factor – Test Year Cost Factor).

13

14 Q. Do you have any additional comments regarding Az-Am's recommended
15 treatment of the acquisition adjustment?

16 A. Yes. Mr. Stephenson recommends (p. 17), "[T]hat the decision to allow
17 the recovery of any acquisition adjustment should be based on Arizona-
18 American's ability to demonstrate that clear, quantifiable and substantial
19 net benefits exist, as recommended by Staff." I also agree with Staff's
20 recommendation as I understand it. However, I am concerned that Az-
21 Am's interpretation of that recommendation and Az-Am's use of that
22 recommendation in proposing the amount of acquisition adjustment for

1 recovery in its next rate case is not consistent with my understanding of
2 Staff's recommendation. For example, the phrase "based on" is nebulous
3 and does not necessarily limit the recovery to the amount of the clearly
4 quantified net benefit. The definition of "net benefit" is subject to many
5 abuses. If such a definition is to serve as the basis for the recoverable
6 acquisition adjustment, it must be more specific than that supported by
7 Staff and Az-Am.

8
9 **OTHER ISSUES**

10 Q. Do you agree with Mr. Stevenson's rebuttal comments (page 3) that
11 deferred income taxes and investment tax credits can be addressed in the
12 next rate case?

13 A. I agree that the determination of the amount of any adjustments related to
14 deferred income taxes and investment tax credits can be deferred to the
15 next rate case, however, the Commission should evaluate the impact
16 these items will have on future rates in determining in this case if the
17 transaction is in the public interest. E.g., the Commission could determine
18 in this case that the incremental revenue requirement due to the
19 elimination of deferred income tax credits and investment tax credits
20 combined with other aspects of the proposed transaction provide a result
21 that is not in the public interest.

1 **GETTING THE PERSPECTIVE RIGHT**

2 Q. Please comment on Mr. Stevenson's rebuttal (pages 16 and 17) estimates
3 of the financial effects of RUCO's recommendations.

4 A. Mr. Stephenson states, "No one would benefit from a transaction that
5 would result in negative net income for Arizona-American." I agree with
6 that portion of his comments. However, Mr. Stephenson has incorrectly
7 attributed the shortcomings of the joint application to RUCO's
8 recommendations. Mr. Stephenson opines (page 8) that the upward
9 influence on rates for Citizens' Arizona water and wastewater customers
10 of more than a hundred million dollars due to: (1) elimination of AIAC; (2)
11 elimination of CIAC; (3) elimination of ADIT; (4) loss of a majority Citizens'
12 low-cost IDRBs; and (5) recovery of a \$71.2 million dollar acquisition
13 adjustment should not even be considered in determining whether the
14 transaction is in the public interest. According to Mr. Stephenson, the
15 relevant statute ". . . appears to be intended to ensure that the ability of
16 the transferring utility to furnish service is not impaired."

17
18 Mr. Stephenson must take this extreme position by necessity. As Mr.
19 Stephenson concluded, the terms of the transaction, as proposed in the
20 joint application, are such that when adjusted to hold ratepayers harmless,
21 Az-Am cannot earn a fair rate of return on the investment. Neither RUCO
22 nor the ratepayers can be held accountable for the terms of the Asset

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1 Purchase Agreement. Ratepayers should not be harmed due to an
2 agreement between two utilities in which the ratepayers had no input. If,
3 as Mr. Stephenson concluded, no-one would benefit from the transaction,
4 then, the transaction should be rejected and the burden it would place on
5 all parties avoided.

6

7 Q. Does this conclude your surrebuttal testimony?

8 A. Yes.

9

10

11

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(Corrections to Direct Testimony)

Page 13, line 1, insert "its" after "in" and before "testimony"

Page 19, line 20, insert "from regulated operations" after "premium"

Page 20, line 3, delete “cost” and insert “costs”

Page 31, line 3, delete "compensation" and insert "compensatory"

Page 33, line 16, delete "shareholders" and insert "ratepayers"

Page 34, line 8, delete “affiliates” and insert “affiliates”

Page 34, line 9, delete “Utility” and insert “Utilities”

CITIZENS UTILITIES COMPANY
ARIZONA-AMERICAN WATER COMPANY
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DIRECT TESTIMONY

OF

GORDON FOX

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

AUGUST 14, 2000

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INTRODUCTION

Q. Please state your name and business address.

A. My name is Gordon L. Fox. My business address is 2828 North Central Avenue, Suite 1200, Phoenix, AZ 85004.

Q. By whom are you employed and in what capacity?

A. The Residential Utility Consumer Office (RUCO) employs me in the position of Utilities Chief Rate Analyst.

Q. Briefly summarize your educational and professional credentials related to your work in the field of utility regulation.

A. I have Master and Bachelor of Science Degrees in Accounting. I have earned the following professional accounting and finance certifications: Certified Public Accountant (CPA); Certified Management Accountant (CMA); and Certified in Financial Management (CFM). My utility experience includes three years in my current position, seven years in various auditing and rate analyst positions with the Arizona Corporation Commission and four years with a cable TV utility with responsibility for preparing and presenting rate applications before jurisdictional authorities.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to present findings and recommendations resulting from my review and analysis of the joint application of Citizens Utilities Company, Inc. (Citizens) and Arizona-American Water Company (Az-Am) for the sale of essentially all

1 of Citizens' water and wastewater assets in Arizona and the transfer of the certificates
2 of convenience and necessity (CC&N) to Az-Am for the following divisions and
3 subsidiaries: Agua Fria Division; Mohave Water Division; Sun City Water Company; Sun
4 City Sewer Company; Sun City West Utilities Company; Citizens Water Service
5 Company of Arizona; Citizens Water Resources Company of Arizona; Havasu Water
6 Company; and Tubac Valley Water Company, Inc.

7
8 **CITIZENS**

9 Q. Please provide a brief description of Citizens and its Arizona water and wastewater
10 properties.

11 A. In 1998 Citizens (headquartered in Stamford, CT) served 1,820,444 customers in 22
12 states with gas, electric, water, wastewater, and telecommunications services. Citizens
13 provides all of these services in Arizona. In 1998 Citizens had total assets of \$5.293
14 billion, generated revenues of \$1.542 billion and earned a net income of \$57.1 million.
15 Citizens capital structure consists of approximately 45 percent common equity, 5
16 percent preferred stock, and 50 percent long-term debt (weighted average cost is 6.71
17 percent). In October 1999, Citizens announced the sale of its water and wastewater
18 utilities for \$835 million and of its electric utilities for \$535 million. Citizens is also
19 seeking to divest of its gas distribution utilities. The proceeds of these divestitures are
20 being used to acquire telecommunications assets. A new name, Citizens
21 Communications, was adopted on May 18, 2000 to reflect the new focus of business
22 operations. Citizens' common stock is traded on the New York Stock Exchange under
23 the trading symbol CZN.
24

1
2 According to the 1999 Annual Report to the Arizona Corporation Commission, Citizens
3 provided water and wastewater services to 118,796 Arizona customers in 1999
4 (approximately 86 percent in Maricopa County, 13 percent in Mohave County and less
5 than 1 percent in Santa Cruz County) and had total assets of \$190.1 million. In 1999,
6 water and wastewater operations generated revenues of \$31.1 million and provided net
7 income of \$3.4 million.
8

9 **ARIZONA-AMERICAN**

10 Q. Please provide a brief description of Az-Am (formerly Paradise Valley Water Company)
11 and its parent American Water Works Company, Inc. (AWW).

12 A. Az-Am currently provides potable water service to approximately 4,600 customers in
13 Paradise Valley, Arizona and is a wholly owned subsidiary of AWW. In 1999 AWW
14 (headquartered in Voorhees, NJ) and its subsidiaries served 2,516,000 customers in 23
15 states with water and wastewater services making it the nation's largest investor-owned
16 water utility company. AWW generated approximately 98 percent of its consolidated
17 operating revenue from water services and two (2) percent from wastewater services in
18 1999. On a consolidated basis, AWW had total assets of \$6.0 billion, operating
19 revenues of \$1.3 billion, and net income of \$138 million. For 1999, the capital structure
20 of AWW consisted of 39 percent common equity, 2 percent preferred stock, and 59
21 percent long-term debt (weighted average cost is 7.29 percent). AWW common stock is
22 traded on the New York Stock Exchange under the trading symbol AWK.
23
24

SALE AND TRANSFER TRANSACTION - PROPOSED

Q. Please describe the proposed sale and transfer transaction between Citizens and Az-Am.

A. On October 15, 1999, Citizens and Az-Am entered into an Asset Purchase Agreement (Agreement). The Agreement sets forth the terms and conditions for the transfer of Citizens' Arizona water and wastewater assets, rights, and obligations, with specified exceptions, and for the transfer of Citizens' Certificates of Convenience and Necessity (CC&N) to Az-Am.

Q. Please explain Citizens' motivation for this transaction.

A. According to Citizens' 1999 annual report, the Company has made a strategic change to divest its public utility operations (water, wastewater, gas, and electric) and to invest the proceeds in telephone access lines. Citizens' management noted two reasons for the strategic change in focus. First, "approximately 2 million telephone access lines in the rural and suburban areas that are Citizens' market focus came available for acquisition." Second, "Doubt-digit multiples of cash flow [for telecommunications] in contrast to the single-digit multiples of cash flow utility companies traded at in public markets."

Q. Please explain AWW's motivation for this transaction.

A. The acquisition of Citizens' Arizona water and wastewater properties advances AWW's goals for geographic diversity and enhances the potential for improving operating and financing efficiencies.

1 Q. What is the purchase price for the Arizona Assets?

2 A. The exact purchase price will not be determined until the transaction is completed
3 because the Agreement provides for adjustments in changes to net plant, assumed
4 liabilities, and other items. Without the affects of these adjustments, the purchase price
5 is \$231,310,000.
6

7 **ACCOUNTING ORDER - REQUESTED**

8 Q. Does the joint application make a request other than for approval of the transaction?

9 A. Yes. Az-Am is also requesting an accounting order authorizing use of the "Mortgage
10 Amortization" method for amortizing the excess of the purchase price over book value of
11 the assets (acquisition adjustment).
12

13 **ISSUES**

14 **Main Extension Agreements/AIACs/CIACs**

15 Q. How does Az-Am plan to treat the advances-in-aid-of-construction (AIAC) and
16 contributions-in-aid-of-construction (CIAC) recorded by Citizens' pertaining to main
17 extension agreements?

18 A. In response to RUCO data request 1.10, Az-Am asserted that it is purchasing Citizens'
19 assets, including plant financed with advances, however, Az-Am is not assuming the
20 liability for the advances nor recording the advances on its books. In other words, Az-
21 Am intends to eliminate all AIAC and CIAC balances as a consequence of acquiring
22 Citizens' assets.
23
24

1 Q. What would be the consequence of treating AIAC and CIAC as proposed by Az-Am?

2 A. AIAC and CIAC are deductions in the calculation of rate base. According to the 1999
3 Annual Reports filed with the Arizona Corporation Commission (Commission or ACC)
4 for the Citizens' properties in this transaction (Arizona Properties), the balances for
5 AIAC and CIAC at the end of 1999 were \$80,818,669, and \$4,734,430, respectively, for
6 a total of \$85,553,099. In a rate proceeding, rate base would be reduced by
7 \$85,553,099 for AIAC and CIAC.

8
9 Q. Do AIAC and CIAC represent significant amounts in comparison to Citizens' combined
10 rate base?

11 A. Yes. Normally, Net Plant represents the majority of a utility's rate base. According to
12 the 1999 Annual Reports filed with the Commission, the Net Plant for the Arizona
13 Properties at the end of 1999 was \$168,128,039. The combined value of AIAC and
14 CIAC represents 50.9 percent ($\$85,553,099 / \$168,128,039$) of Net Plant. Accordingly,
15 I anticipate that Az-Am's proposed elimination of AIAC and CIAC in this transaction, if
16 allowed, would approximately double the size of the rate base upon which Az-Am's
17 operating income and revenue requirement is determined.

18
19 Q. What is the purpose of AIAC?

20 A. AIAC are advances of funds to a utility by customers or developers that are used,
21 generally, to finance plant extensions to new customers where that plant extension is
22 not otherwise economically feasible. Advanced funds carry no interest charges; they
23 represent zero cost capital. The use of AIAC prevents subsidization by existing
24

1 customers of new customers in non-economical, or potentially non-economical areas.
2 Normally, advance contracts for water and wastewater expire in 10 and 5 years,
3 respectively. Upon expiration, non-refunded AIAC is converted to CIAC.
4

5 Q. Is the purpose of recognizing AIAC in the ratemaking process preserved by the
6 structure of the proposed transaction and Az-Am's proposed treatment of AIAC?

7 A. No. The transaction is structured to eliminate AIAC, increase rate base, increase rates
8 causing existing ratepayers to subsidize non-economical development and requiring
9 ratepayers in non-economical areas to pay twice for a portion of the cost of plant
10 extended to their area.
11

12 Q. How could the annual revenue impact of eliminating AIAC and CIAC from rate base be
13 estimated?

14 A. AIAC impacts the revenue requirement via operating income, income taxes and
15 depreciation expense. Depreciation expense is affected because the annual
16 amortization of CIAC is an offset to depreciation under the ACC authorized National
17 Association of Regulatory Water Utilities (NARUC) Uniform System of Accounts
18 (USOA). E.g., assuming the composite depreciation rate is four (4) percent, the
19 reduction in depreciation expense and revenue requirement pertaining to CIAC is
20 \$189,377 (\$4,734,430 CIAC x .04 depreciation rate). Assuming a weighted average
21 cost of capital of 8.55 percent (Az-Am used 8.55 percent to discount cash flows in its
22 synergy analysis, Tab 1 attached to Mr. Stevenson's direct testimony), the required
23 operating income would increase by approximately \$7.3 million (\$85.6 million (AIAC &
24

1 CIAC) x 0.0855 (cost of capital) due to elimination of the AIAC. Assuming a revenue
2 conversion factor of 1.5 to recognize the effect of income taxes, the overall additional
3 annual revenue requirement resulting from the elimination of AIAC and CIAC before
4 consideration of accumulated deferred income tax is approximately \$11.0 million [(\$7.3
5 million x 1.5) + \$0.2 million CIAC amortization]. After adjusting for an accumulated
6 deferred income tax debit related to the AIAC and CIAC, the net overall additional
7 annual revenue requirement resulting from the elimination of AIAC and CIAC is
8 approximately \$10.4 million (\$11.0 million – (\$6.7 million related ADIT x 0.0855)).
9

10 Q. Does the "Synergy Analysis" attached as Tab 1 to Mr. Stephenson's direct testimony
11 recognize any impact due to the elimination of AIAC and CIAC?

12 A. No. RUCO data request 2.4(c), requested identification of the amount(s) reflected in the
13 synergy analysis pertaining to Az-Am not assuming Citizens' AIAC. Az-Am's response
14 stated, "[N]one."
15

16 Q. Is the \$10.4 annual revenue impact of the loss of AIAC and CIAC significant to Az-Am's
17 synergy analysis?

18 A. Yes. If Az-Am had included this factor in its synergy analysis the impact on the results
19 would have been dramatic. A perspective of the magnitude of a \$10.4 million revenue
20 effect can be obtained by recognizing that the combined 1999 operating revenue from
21 the Arizona Properties was \$31.1 million. Thus, the \$10.4 revenue effect due to the
22 AIAC and CIAC is approximately one-third of total operating revenue. That is, loss of
23 the AIAC and CIAC will increase the revenue requirement by a third.
24

Citizens' Gain

Q. Under terms of the Agreement will Az-Am purchase the Arizona Properties for more than book value?

A. Yes. The purchase price stated in the Agreement is \$231,310,000. Information in Az-Am's response to RUCO data requests 1.2 and 1.3 shows that the purchase price is comprised of three major components:

- (1) Net book value of assets purchased, \$149,523,861;
- (2) Assumed IDR obligation, \$10,635,000; and
- (3) Gain on sale, \$71,159,139.

Q. How does Citizens' plan to treat the \$71.2 million gain?

A. In response to RUCO data request 1.2, Citizens stated, "Citizens does not plan to share any portion of any gain on the sale with customers."

Q. How has the Commission traditionally treated gains on the sale of assets?

A. The Commission treats each sale on an individual basis. According to the National Association of Regulatory Utility Commissioners (NARUC) Uniform System of Accounts (USOA) for water utilities and for wastewater utilities that the Commission has adopted, gains on the sale of assets are treated as operating or non-operating, as approved by the Commission. My understanding is that the Commission normally provides for a sharing between shareholders and ratepayers, i.e., the gain is divided and partially recognized as operating and partially as non-operating. In my opinion, a sharing of the gain is the correct treatment in normal circumstances.

1 Q. Why is sharing the gain between shareholders and ratepayers the correct treatment in
2 normal circumstances?

3 A. The parties that share in the risks related to utility assets should be entitled to share in
4 the gain on the sale of those utility assets. Using the accounting treatment prescribed in
5 the USOA, when an asset is retired before a utility fully recovers its original cost via
6 depreciation, accumulated depreciation is debited (reduced). The effect of the USOA
7 treatment is to make the utility whole, i.e., the utility does not recognize a loss on the
8 early retirement and rate base is preserved at the pre-retirement level. This treatment
9 transfers the risk of assets becoming obsolete or wearing out prematurely from the
10 utility to the ratepayers. Further, ratepayers pay a return on the assets on an on-going
11 basis. Thus, ratepayers participate in the risks of asset ownership with the utility, and
12 accordingly, are entitled to share in gains from the sale of those assets as directed by
13 the Commission and in accordance with the USOA allowed treatments.

14
15 **Arizona-American's Premium**

16 Q. How is Az-Am proposing to treat the \$71.2 premium (acquisition adjustment)?

17 A. In response to RUCO data request 2.1, Az-Am stated:

18
19 "The Company has not made any proposal whether it will or will not seek
20 the entire Acquisition Adjustment in rates, or even seek some other
justifiable amount."

21
22 Thus, Am-Az has not committed to requesting recovery in rates of any specific amount
23 of the acquisition adjustment nor has the Company committed to any specific method
24

1 for determining the amount for recovery. Page 6 of the direct testimony of Az-Am's
2 witness, Mr. Stephenson, states:

3
4 "The ratemaking treatment of the acquisition adjustment and the related
5 amortization would be determined in Az-Am's next general rate
6 proceeding. Az-Am is not requesting that treatment for ratemaking
7 purposes be determined at this time. However, Az-Am does seek an
8 accounting order in regard to the amortization period and methodology to
9 be used."

10 Az-Am is not proposing a specific amount or a method for determining the amount of
11 the premium to be recovered in rates. Az-Am is, however, requesting an accounting
12 order authorizing use of a specific method and period, for recovering the amount, if any,
13 of the premium that the Commission ultimately authorizes for recovery.

14 Q. What accounting method and period is Az-Am requesting that the Commission
15 authorize related to the acquisition adjustment?

16 A. Az-Am is proposing to use the "mortgage amortization" method and a forty-year
17 amortization period.

18 Q. How does the mortgage amortization compare with the more frequently used straight-
19 line amortization method?

20 A. In the straight-line amortization method, an equal amount of principal is recovered each
21 period and the amount of interest decreases each year. Thus, use of the amortization
22 method instead of the straight-line method reduces the recovery in the early years and
23 increases the recovery in the later years. In effect, the amortization defers cost
24

1 recovery to later years and requires ratepayers to pay a return on the deferred amount.
2 However, the mortgage amortization method is more palatable initially due to the lower
3 revenue requirement in the first years of the amortization period.
4

5 Q. In what situation is the mortgage amortization method appropriate?

6 A. The mortgage amortization method can be used to reduce the initial impact on rates
7 due to a large addition to rate base. That is, the mortgage amortization method can be
8 used to mitigate the impact of a large rate increase and prevent rate shock. The
9 mortgage amortization method can mitigate the impact of a large addition to rate base
10 by equalizing the amount of the revenue recovered in each period while providing
11 recognition for the time value (cost) of money. Although, the revenues are equal in
12 each period, the portions that represent principal and interest vary each period. The
13 amount represented by principal grows each year and the amount represented by
14 interest decreases each year until the principal is fully amortized.
15

16 Q. What is the implication of Az-Am's request to account for the acquisition adjustment
17 using the mortgage amortization method?

18 A. The request implies there is a need to mitigate a substantial rate increase. This is
19 inconsistent with the transaction being in the public interest.
20
21
22
23
24

1 Q. What reason has Az-Am stated in testimony for requesting an accounting order for the
2 use of the mortgage amortization method?

3 A. According to Mr. Stephenson's direct testimony (pp. 6 and 7), the mortgage
4 amortization method has several benefits including level annual recovery that provides
5 for easier comparisons between synergy savings and the revenue requirement related
6 to the acquisition adjustment.
7

8 Q. Is use of the mortgage amortization method necessary to allow comparisons between
9 synergy savings and the revenue requirement related to the acquisition adjustment?

10 A. No. Use of the mortgage amortization method is neither necessary to make
11 comparisons nor does it necessarily make comparisons easier.
12

13 Q. Has Az-Am provided any other comments regarding the benefit of using of the
14 mortgage amortization method?

15 A. Yes. In response to RUCO data request 2.1(f), Az-Am stated:
16

17 "If the ACC permits the Acquisition Adjustment to be amortized over
18 a specific time period as an allowable cost for rate-making
19 purposes, the regulator's action provides reasonable assurance of
20 the existence of an asset under paragraph 9 of FAS No. 71. The
21 Acquisition Adjustment would then be amortized for financial
22 reporting purposes over the period during which it will be allowed
23 for rate-making purposes. In this case no regulatory asset can be
24 established before the ACC has specified an amount for recovery.
Any portion of the Acquisition Adjustment that is not authorized for
recovery in rates by the ACC would have to be amortized on a
straight-line basis."

1 Q. Could you clarify the requirement of Financial Accounting Standards (FAS) No. 71,
2 Accounting for the Effects of Certain Types of Regulation, as it pertains to the
3 acquisition adjustment?

4 A. Yes. FAS No. 71 is a generally accepted accounting principle (GAAP). Az-Am and its
5 parent AWW will want to comply with GAAP in preparing the consolidated annual
6 financial statements for external reporting purposes. FAS No. 71 requires that before
7 an incurred cost (in this case, an acquisition adjustment) that would otherwise be
8 charged to expense is capitalized or deferred, it must be probable that future revenue in
9 an amount at least equal to the capitalized cost will result from inclusion of the cost in
10 rates. That is, only the portion of the acquisition adjustment that is probable that the
11 Commission will allow for recovery in rates can be capitalized for purposes of
12 presenting the external financial statements. The remaining portion must be expensed.
13 Thus, the Company will not be able to capitalize any portion of the acquisition
14 adjustment on its external financial statements unless and until the Commission
15 authorizes a specific amount for recovery because the amount of probable recovery will
16 not be known. Until the Commission determines what amount, if any, of the acquisition
17 adjustment it will allow for recovery, the requested accounting order is of no benefit to
18 Az-Am.

1 Q. What relevance does the "Synergy Analysis" attached as Tab 1 to Mr. Stephenson's
2 direct testimony have to the acquisition adjustment?

3 A. Page 8 of Mr. Stephenson's testimony states, "[T]he intent of the Synergy Analysis is to
4 provide the Commission with supportable evidence that the customers will in fact benefit
5 from this transaction."
6

7 Q. Does the synergy analysis demonstrate that ratepayers will benefit from the
8 transaction?

9 A. No. As Mr. Stephenson reveals on page 8 of his testimony, the synergy analysis is
10 incomplete. While not every detail of every analysis for every purpose must be
11 complete to be useful, omission of a single significant item can result in misleading
12 information and erroneous conclusions. As noted previously, the synergy analysis does
13 not include any consideration for the estimated loss of AIAC and CIAC due to the
14 transaction. The omission of the AIAC and CIAC loss results in an overstatement of the
15 Company-estimated synergy savings by approximately \$10.4 million in the first year.
16 Similar impacts due the loss of AIAC and CIAC could be projected for subsequent
17 years. The future value of this \$10.4 million omission exceeds the projected synergy
18 savings in each of the 40 years of the synergy analysis. For example, in Az-Am's
19 synergy analysis, the largest projected synergy savings is in year 38 for the amount of
20 \$38,650,928. Using 8.55 percent as the discount rate, the present value of \$38,650,928
21 is \$1.7 million. Alternately, \$10.4 million invested at 8.55 percent per annum would
22 grow in value to \$234.9 million in 38 years. Thus, the loss of AIAC and CIAC in year
23 one has more than six times the detrimental value for ratepayers than the synergy
24

1 savings benefit at its peak in year 38. Az-Am's omission of the consequences of a
2 single item, the loss of the AIAC and CIAC, has greatly skewed the Company's synergy
3 analysis and is misleading.

4
5 An examination of Az-Am's synergy analysis shows that there is no cumulative benefit
6 to ratepayers in the first eight years. Normally, most cost projections extending beyond
7 three to five years are considered speculative. In fact, Az-Am's own synergy analysis
8 shows a detriment to ratepayers within the period a reasonably accurate projection can
9 be made. Even costs under long-term contracts can change unexpectedly due to
10 renegotiations and other factors. Refunding of a bond is an example of a relatively
11 frequent change in long-term costs.

12
13 Q. How can Az-Am's synergy analysis be used?

14 A. The forty-year analysis provided by Az-Am is virtually useless. In data request 2.1(h)
15 RUCO asked Az-Am to identify all of the reasons the Company used to conclude that
16 forty years is an appropriate period for projecting synergy cost savings and the
17 Company provided the following response:

18 "Synergy cost savings are projected over 40 years so that the
19 projected cumulative net saving between the 40-year revenue
20 requirement of the Acquisition Adjustment and the 40-year
21 projected Synergy Savings can be shown."

22 A proper analysis would show the present value of all cash flows that can be projected
23 with reasonable accuracy. Matching of the revenue recovery and synergy savings
24 years is not the applicable basis for the determination of the cash flows to include in the

1 analysis. The ability to place numbers in a schedule and for those amounts to have
2 meaning are two separate issues. Az-Am cannot know or accurately project for 40
3 years into the future: productivity improvements for itself or for Citizens; the effects of
4 changes in management; the effects of new technologies; changes in customers, etc.

5
6 Q. Do the amounts of AIAC and CIAC bring to bear factors relevant to the transaction other
7 than their financial impact on the revenue requirement and the synergy analysis?

8 A. Yes. The large balances of AIAC and CIAC on Citizens' books demonstrates Citizens'
9 good management and success working with developers to provide large amounts of
10 zero cost capital to finance plant. Similarly, Citizens has regularly used cost efficient
11 Industrial Development Revenue Bonds (IDRBs) as a source of capital. These actions
12 by Citizens are providing significant value and benefit to ratepayers that are not
13 apparently reflected in Az-Am's synergy analysis. The substantial economic benefit of
14 the AIAC and CIAC, as previously discussed, will be a substantial challenge for Az-Am
15 to match based on synergy savings.

16
17 Q. Az-Am is proposing to defer the rate-making treatment of the acquisition adjustment to
18 the Company's next general rate case. Can you discuss the merits of the Company's
19 proposed treatment?

20 A. Yes. The normal treatment/ratemaking doctrine for an acquisition adjustment/premium
21 is to ignore the acquisition adjustment for rate-making purposes. That is, the premium
22 is neither included in rate base nor amortized as an operating expense. However,
23 partial recovery of an acquisition adjustment is justifiable and desirable in some
24

1 circumstances (for example, when a more efficient service provider acquires the
2 operations of an under-performing and inefficient service provider.) The appropriate
3 circumstances for allowing recovery of at least a portion of an acquisition adjustment in
4 rates would require a demonstration of net benefits to ratepayers that would not have
5 occurred absent the acquisition. Accordingly, determination of the amount of the
6 acquisition adjustment to be recovered, if any, must be deferred until the acquiring
7 company has had an opportunity to demonstrate net benefits to customers. However, it
8 is appropriate to establish circumstances, guidelines, and limitations pertaining to any
9 potential future recovery of an acquisition adjustment at the time the transaction is
10 approved.

11
12 Demonstration of net benefits to customers is somewhat subjective and, therefore,
13 subject to abuse. For example, an acquiring company may be able to demonstrate that
14 administrative and general expenses declined, however, fail to recognize offsetting
15 increases in other operating and capital costs. A change in operating methods may
16 cause labor costs to decrease while simultaneously increasing depreciation, power, and
17 other expenses completely offsetting the productivity gains in labor costs and resulting
18 in no net benefit. Even an overall reduction in revenue requirement is not sufficient to
19 demonstrate that there is a net benefit related directly to the operations of the acquiring
20 company versus the selling company. The revenue requirement can be lowered due to
21 factors unrelated to the transaction such as a reduction in the market rate for debt and
22 equity capital. Further, the selling company would have been expected to make
23 productivity improvements.

1
2 However, to the degree that the acquiring company can clearly demonstrate and
3 quantify net overall savings related to the acquisition (e.g., due to use of exclusive
4 technology or management practices) based on a comprehensive analysis, I believe a
5 portion of those quantified savings should be eligible for rate recovery.
6

7 There are several reasons why some aspects of the acquisition adjustment should be
8 addressed at the time the transaction. If all aspects were deferred to a future rate case
9 some issues may be overlooked, forgotten, or documentation may be lost or become
10 unusable. The acquiring company will have no motivation to reveal cost increases
11 other than to avoid looking biased by overlooking obvious increases. This lack of
12 motivation is demonstrated in the current case by Az-Am's omission of the effect of the
13 loss of AIAC and CIAC in its synergy analysis.
14

15 Q. Is Az-Am's proposal to defer the determination of the amount, if any, of acquisition
16 adjustment that will be authorized for recovery in rates to the next general rate case
17 consistent with good sense, i.e., is it practical?

18 A. Yes, to the extent that there is a normal rate-making doctrine, as discussed later,
19 establishing a guideline that places Az-Am on notice that recovery of any premium is
20 unlikely and the Company has accepted that it will not recover the premium. However,
21 there are no apparent non-regulatory operations from which Az-Am can recover the
22 premium. Utilities often expend considerable resources in an attempt to gain a few
23 additional basis points in the authorized rate of return. It is inconsistent for Az-Am not
24

1 be equally concerned as to whether it earns on an investment of \$231.3 million versus
2 \$160.2 million unless the \$71.2 million premium can be recovered by lower operating
3 and financing cost before the next rate filing. In response to RUCO data request 2.1(i),
4 asking Az-Am how it could proceed with a decision to acquire or not acquire the Arizona
5 Properties prior to knowing the amount, if any, of the acquisition adjustment that the
6 Commission will allow for recovery, the Company responded:

7
8 "The Company is confident that a financially viable resolution will be
9 rendered in the application that will request rate recognition of the
10 Acquisition Adjustment."

11 Q. From the perspective of ratepayers, does deferring a determination regarding the
12 amount, if any, of the \$71.2 million acquisition adjustment until Az-Am's next general
13 rate case affect the propriety of recommending authorization of the transaction?

14 A. Yes. Sufficient limitations must be placed on the conditions and amount of the premium
15 that is potentially recoverable to insure that the acquisition will be in the public interest.
16 That is, restrictions must be placed on the amount of the recoverable premium to lower
17 the risk that this transaction will not be beneficial to ratepayers. At this time, the
18 evidence does not warrant a recommendation authorizing the transaction exposing
19 ratepayers to a potential increase in rate base of \$71.2 million unless appropriate
20 limitations are placed on the amount of the acquisition adjustment that is recoverable. I
21 will be recommending limitations that I believe are appropriate.
22
23
24

1 Q. What is the normal treatment of an acquisition adjustment/premium?

2 A. Traditional rate-making doctrine is to ignore the acquisition adjustment for rate-making
3 purposes. That is, the premium is neither included in rate base nor amortized as an
4 operating expense.

5
6 Q. Can Az-Am potentially recover its acquisition adjustment from ratepayers without the
7 Commission allowing for such recovery in a future rate case?

8 A. Yes. Cost reductions achieved by Az-Am before its next rate case can be retained for
9 the benefit of the Company's stockholders. By recovering the premium in this way, Az-
10 Am can demonstrate some of the economic benefit to ratepayers that it is projecting will
11 occur.

12
13 **Accumulated Deferred Income Tax and Investment Tax Credits**

14 Q. What are Accumulated Deferred Income Taxes (ADIT) and how do they affect rates?

15 A. ADIT is the net amount of Deferred Income Tax Expense accumulated for prior years.
16 Deferred Income Tax Expense results from timing differences in the recognition of
17 revenues and expenses for the differing purposes of calculating income tax liability and
18 revenue requirements in ratemaking. ADIT credits represent a utility's collection of
19 revenues from ratepayers in years prior to making remittances to state (Arizona
20 Department of Revenue) and federal (U.S. Treasury) authorities. That is, ADIT credits
21 represent payments ratepayers have made in advance for future income tax liabilities.
22 ADIT is cost-free capital that reduces rate base, and accordingly, rates.

1 Q. What is the combined amount of Net ADIT shown in Citizens' 1999 annual reports to the
2 Commission for the Arizona Properties?

3 A. The combined amount shown in Citizens' 1999 annual reports for the Arizona
4 Properties is an ADIT credit of \$5,267,029.

5
6 Q. Will these ADIT credits transfer to Az-Am?

7 A. No. The sale of AED's assets is a taxable event that will cause the deferred taxes to
8 become due and payable. That is, Citizens will have to pay the income taxes collected
9 in advance from ratepayers to the tax collection authorities.

10
11 Q. Will Citizens' be harmed or receive benefits directly related to the payment of these
12 taxes collected in advance?

13 A. No. Citizens will no longer have the advanced capital, however, there will no longer be
14 a reduction to the ratebase upon which Citizens can earn. These items are offsetting.

15
16 Q. Will ratepayers receive any benefit directly related to Citizens' payment of the ADITs
17 that were collected in advance?

18 A. No.

19
20 Q. Will ratepayers be harmed by Citizens' payment of the ADITs that were collected in
21 advance?

22 A. Yes. Since the ADIT will not transfer to Az-Am, Citizens' ADIT credits will no longer be
23 used in the calculation of rate base. Accordingly, rates will increase. Thus, the ADIT
24

1 consequences of the sale neither harm nor benefit Citizens, however there is a benefit
2 to the tax collection authorities at the expense of ratepayers.

3
4 Q. What are Investment Tax Credits (ITCs) and how do they affect rates?

5 A. In certain years provisions of the Internal Revenue Code allowed a reduction to the
6 current federal income tax liability based on a percentage of investments in qualified
7 assets. Regulations allow for the sharing of the benefit of the tax reduction between
8 stockholders and ratepayers primarily via two methods (1) reduction to rate base and
9 (2) amortization to reduce income tax expense.

10
11 Q. What is the combined amount of ITCs shown in Citizens' 1999 annual reports to the
12 Commission for the Arizona Properties?

13 A. The combined amount of ITCs shown in Citizens' 1999 annual reports for the Arizona
14 Properties is \$2,192,378.

15
16 Q. How will the transaction affect the ITCs?

17 A. The ITCs will not transfer to Az-Am and Citizens' ITCs will no longer be used in the
18 calculation of rate base or as an amortization to reduce income tax expense.
19 Accordingly, rates will increase.

Industrial Development Revenue Bonds

Q. Please define an IDRB.

A. Each year the U.S. Congress establishes a total amount of debt that can be issued by nonprofit Industrial Development Authorities (IDA) in each county in the United States. The amount of debt issuing authority attributed to each county is determined by its population. IDAs have authority established by the U.S. Congress in the Tax Reform Act of 1986 to issue bonds on behalf of third parties engaged in certain, usually construction, activities that are deemed to be in the public interest. The IDAs enter into agreements to loan the proceeds to entities such as Citizens that will use the funds for the public good.

Q. Do IDRBs have any particular benefit to utilities and ratepayers?

A. Yes. Generally, IDRBs are exempt from federal income taxation. The tax-exempt feature of IDRBs makes them more attractive to potential buyers of bonds than taxable bonds. Thus, bond buyers are willing to accept a lower interest earnings rate. The lower interest rate reduces interest expense to the issuing utility. In turn, the reduced interest expense is passed on to ratepayers in the form of a lower cost of capital in rate proceedings.

Q. What is the combined outstanding balance of Citizens' Arizona Properties' IDRBs?

A. Schedule I attached to the Agreement shows that four IDRB series were issued by the Industrial Development Authority of the County of Maricopa: (1) Year 1985 for \$3,150,000; (2) Year 1988 for \$10,635,000; (3) Year 1991 for \$7,000,000; and (4) Year

1 1995 for \$13,500,000 for a total of \$34,285,000. However, in response to RUCO data
2 request 1.7, Citizens provided a schedule showing the \$10,635,000 issuance from 1988
3 as the only outstanding IDR. RUCO has sent data request 3.1 asking for clarification
4 regarding the correct outstanding balance of IDRs. RUCO has not received a
5 response at the time of this testimony is being prepared.
6

7 Q. How will the 1988 series IDR for \$10,635,000 be treated under the terms of the
8 Agreement?

9 A. Page 4 of the joint application asserts that the purchase price includes the assumption
10 of \$10,635,000 of debt in the form of IDRs. An attachment to the Agreement also
11 shows the 1988 series IDR as an assumed liability. That is, Az-Am will assume the
12 1988 series IDR from Citizens.
13

14 Q. Is Az-Am's assumption of Citizens' IDRs desirable?

15 A. Yes. IDRs are a low-cost source of capital. Low-cost capital helps reduce the
16 revenue requirement. The average cost on the \$10,635,000 series 1988 IDR for the
17 year 1999 was 3.55 percent per annum.
18

19 Q. What is the primary concern regarding IDRs and the proposed transaction?

20 A. The primary concern is that there may be three IDR issuances with an aggregate
21 principal of \$23,650,000, as listed previously, that represent additional low-cost capital
22 that is not being assumed by Az-Am. The additional cost to replace these IDRs with
23 alternative capital financing sources could be valued in the tens of millions to Az-Am
24

1 and ratepayers over the terms of the bonds. The loss of these IDRBs would be
2 detrimental to ratepayers and cause rates to increase. I reserve the opportunity to
3 further address this issue pending receipt of a response to RUCO data request 3.1.
4

5 **Another Public Interest Consideration**

6 Q. Does the joint application identify any potential benefit to the public resulting from the
7 transaction that addresses a particular need in Arizona?

8 A. Yes. Arizona has a large number of small water companies. Many of these small water
9 companies are technologically, managerially, operationally, and financially challenged
10 resulting in insufficient and/or inadequate service. The Commission was sufficiently
11 concerned by service quality problems to establish a water task force to address this
12 issue. At this time there has been no agreement or policy established specifically to
13 resolve problems related to resource challenged utilities. Page 5 of the joint application
14 asserts that one of the advantages to Az-Am's affiliation with AWW is, "[E]nhanced
15 ability of the combined entity to acquire small and/or distressed water and wastewater
16 companies." Az-Am's witness, Mr. Daniel L. Kelleher embellishes on this issue stating:

17 "Third, the combined entity will be in a better position to continue its
18 participation in the ongoing water industry consolidation. For the reasons
19 previously stated, such strategic goals are essential if AWW is to fulfill its
20 responsibilities to both its ratepayers and shareholders. In addition, such
21 consolidation will permit the combined entity to be better positioned to
22 expand and accelerate the acquisition of, or to provide assistance to,
23 small, nonviable Arizona water and wastewater systems. AWW
24 understands that, along with the opportunity to expand our water interests
in Arizona, comes a responsibility to assist in the resolution of the

1 structural problems plaguing the water industry which impede
2 achievement of safe and reliable service to all consumers in Arizona. (pp.
3 8 and 9)."

4 Q. Is Az-Am, with the support of its parent AWW, in a position to assist in the resolution of
5 some to the problems of Arizona's resource challenged water and wastewater utilities?

6 A. Yes. As the nation's largest investor owned water company, AWW has the technical,
7 managerial, operational, and financial ability to enhance service quality via acquisition
8 and other assistance to Arizona water and wastewater companies. As presented in Mr.
9 Kelleher's testimony (p. 13), AWW had investments in water utility plant of
10 approximately \$6 billion at the end of 1999 and expended \$467 million for construction
11 alone in 1999. Even a small percentage of those amounts would substantially impact
12 service quality in Arizona.

13
14 Q. Do you agree with Mr. Kelleher that the opportunity to acquire Arizona utilities comes
15 attached with the responsibility to assist in resolving the problems of Arizona's utilities?

16 A. Yes. The Arizona Properties Az-Am is proposing to acquire from Citizens represent
17 some of the largest, best managed, operated, and financed water and wastewater
18 utilities in Arizona. The Arizona Properties that are the subject of this transaction, at
19 least for the most part, represent the standard in service quality for other Arizona
20 utilities, i.e., these are not among the resource challenged utilities. It seems appropriate
21 that along with the opportunity to acquire prime Arizona utilities comes the obligation to
22 acquire some resource challenged utilities to improve the overall quality of service in
23 Arizona.
24

CONCLUSIONS AND RECOMMENDATIONS

Q. Based on your analysis, is Az-Am a suitable owner-operator for the Arizona Properties?

A. Yes. Az-Am backed by its parent AWW has the technical, managerial, operational and financial capabilities to adequately provide public service to the Arizona Properties.

Q. Did your analysis reveal any significant potential detrimental impacts for ratepayers that may result from Citizens' sale of assets and transfer of CC&N's to Az-Am as proposed in the joint application?

A. Yes. My analysis shows that several aspects of the transaction, as proposed, will have or have the potential to significantly affect ratepayers in a detrimental manner including: (1) Citizens retention of AIAC and CIAC; (2) Citizens' proposal to keep 100 percent of the gain for shareholders; (3) Az-Am's potential \$71.2 million request for recovery of the acquisition adjustment; (4) the loss of Citizens' accumulated deferred income taxes and investment tax credits; and (5) if applicable, Citizens' retention of some of the low-cost Industrial Development Revenue Bonds.

Q. Please provide a brief explanation of the effect of Citizens retention of the AIAC obligations and CIAC.

A. The transaction, as proposed, would result in loss of the existing balances for AIAC and CIAC in the determination of rate base. The combined book balance for AIAC and CIAC at the end 1999 for the Arizona Properties was \$85.6 million, approximately one-half the value of net plant (\$168.1 million). Rate base would be approximately doubled

1 by the elimination of the existing AIAC and CIAC causing a significant increase in the
2 revenue requirement and rates.

3
4 Q. Do you agree with Citizens' proposal to keep 100 percent of the gain for shareholders?

5 A. No. Citizens' proposal is one-sided, unfair, fails to recognize the risk ratepayers have
6 incurred related to the assets, and is inconsistent with the Commission's normal
7 treatment as allowed by the NARUC USOA.

8
9 Q. What have you concluded regarding Az-Am's proposal to defer consideration of the
10 \$71.2 million acquisition adjustment to the next general rate case?

11 A. I agree that deferral of the amount, if any, for possible recovery in rates to the next rate
12 case is appropriate. Such deferral treatment affords the Company the opportunity to
13 demonstrate that the acquisition has provided a net benefit to ratepayers. However, the
14 circumstances, guidelines, and limitations pertaining to the amount allowed for recovery
15 should be established in this acquisition proceeding. In the absence of such criteria, the
16 risk to ratepayers of a potential \$71.2 million addition to rate base in the form of an
17 acquisition adjustment is excessive and not in the public interest. Also, advance notice
18 regarding the criteria for recovering a premium will have multiple benefits to the
19 acquiring Company.

1 Q. What will be the effect of eliminating the existing balances for accumulated deferred
2 income taxes and investment tax credits?

3 A. At the end of 1999 the book balances for ADIT credits and ITCs were \$5.2 million and
4 \$2.2 million, respectively, for a total of \$7.4 million. Since ADIT credits and ITCs are
5 reductions in the calculation of rate base, the combined rate base for the Arizona
6 Properties will increase by \$7.4 million causing the revenue requirement and rates to
7 increase in the next rate case.

8
9 Q. Please explain the effects of Citizens retaining, if applicable, any low-cost Industrial
10 Development Revenue Bond obligations.

11 A. Az-Am will have to replace the capital provided by the low-cost IDRBs with alternate
12 and more expensive capital causing upward pressure on rates.

13
14 Q. Based on your analysis, is the transaction as proposed in the public interest?

15 A. No. The economic detriment to ratepayers due to the loss of AIAC and CIAC are very
16 substantial. Ignoring for the moment the detrimental impact on rates caused by losses
17 of ADIT, ITCs, the potential loss of low-cost IDRB capital, and the potential addition to
18 rate base for an acquisition adjustment, the economic value lost by ratepayers due to
19 the loss of AIAC and CIAC is unlikely to be overcome by any synergy savings by Az-
20 Am. Overall Citizens provides good, efficient, cost-effective service in the Arizona
21 Properties. From the ratepayers' perspective, there is no compelling reason to seek
22 new ownership of the Arizona Properties. Thus, there is no reason for the ratepayers to
23 be exposed to the potential of a \$71.2 million premium, the loss of \$85.6 million of zero
24

1 cost capital, and the potential loss of low-cost IDRB capital in exchange for a promise
2 that synergy savings over a mostly speculative forty-year projected period will provide
3 compensation benefits.

4
5 Q. In order to make this transaction in the public interest, what changes do you
6 recommend?

7 A. I recommend that authorization of the transaction be made contingent upon a
8 restructuring or other change in the transaction to compensate ratepayers fully for the
9 loss in economic value due to the loss of AIAC and CIAC.

10
11 Further, I recommend that authorization of the transaction be made contingent upon a
12 restructuring or other change in the transaction to compensate ratepayers fully for the
13 loss in economic value due to the retention by Citizens, if applicable, of any low-cost
14 IDRB capital.

15
16 Further, I recommend that the gain on the sale be divided in equal amounts between
17 Citizens and ratepayers. That is, ratepayers should receive one-half of the gain.
18 Citizens should distribute the gain to each customer by check, based upon total billings,
19 in dollars, for service during the 12-month period ending in the month prior to the
20 completion of the sale and transfer. The distribution to customers should be made no
21 later than 180 days after the close of the transaction based on the actual or the best
22 estimate of the gain, as is applicable, on the ninetieth (90th) day following the close of
23 the transaction.

Further, I recommend that the amount, if any, of the acquisition adjustment to be recovered in rates be determined in the context of the next rate case proceeding where rates are established for all of Citizens' existing divisions and subsidiaries that comprise the Arizona Properties. The criteria for determining the recoverable amount, if any, should be determined in the current proceeding and the amount of the premium allowed should be based on the following criteria:

1. A test year that ends before January 1, 2007.
2. Demonstrated net overall reduction in the annual revenue requirement for the Arizona Properties for the test year compared with Citizens' 1999 operating and capital costs calculated as follows: (Citizens 1999 Operating Expenses¹ - Test Year Operating Expenses) x (Test Year Customers / 1999 Customers) + (Test Year Net Plant) x (1999 Capital Cost Factor - Test Year Capital Cost Factor).

Calculation of 1999 Capital Cost Factor (CCF):

<u>A</u>	<u>B</u>		<u>C</u>	<u>D</u>
<u>Item</u>	<u>Amt</u>		<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
1999 AIAC		x	0%	B x C
1999 CIAC		x	0%	B x C
1999 Plt - Debt/Equity ²	_____	x	WACC ³	<u>B x C</u>
Total 1999 Net Plant	=====			<u>CCF</u>

¹ Per 1999 Annual Reports filed with the Commission.

² Plant balances supported by debt and equity.

Calculation of Test Year Capital Cost Factor (CCF):

<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>
		Cost	Weighted
<u>Item</u>	<u>Amt</u>	<u>Rate</u>	<u>Cost Rate</u>
Test Year AIAC		x 0%	B x C
Test Year CIAC		x 0%	B x C
TY Yr Plt - Debt/Equity ⁴	_____	x WACC ⁵	<u>B x C</u>
Total Test Year Net Plant	=====		<u>CCF</u>

3. The amount resulting from the revenue requirement comparison in condition 2 should be multiplied by a factor not less than three nor greater than five to reflect the number of years' of savings reasonably anticipated and also service quality considerations.
4. The result of condition 3 should be divided by 2 to recognize an equal sharing between stockholders and shareholders to provide the amount, if any, to be allowed for recovery in rates. This sharing serves to recognize Az-Am's obligation as a public utility to provide cost efficient service by flowing one-half of the savings through to ratepayers while at the same time recognizing the Company's achievement in providing cost efficient service by allowing stockholders to retain one-half of the savings.

³ Az-Am's test year weighted average cost of capital.

⁴ Plant balances supported by debt and equity.

1
2 Further, I recommend that authorization of the transaction be made contingent upon Az-
3 Am's Board of Directors approving a letter pledging to invest no less than 15 percent of
4 the purchase price in this transaction in acquisitions and capital improvements of
5 "resource stressed" water and/or wastewater utilities in Arizona no later than 72 months
6 after the date this transaction is authorized by the Commission. Resource stressed
7 utilities shall include Class "C," "D" and "E" water and wastewater utilities regulated by
8 the Commission whose stock or whose affiliates stock is not regularly traded on a major
9 stock exchange and any utility approved by the Director of the Utility Division.

10
11 Further, I recommend that the Az-Am and Citizens jointly file documentation of the final
12 purchase price, net book value of assets sold at the time of the transaction, the amount
13 of the gain/premium, the date of the transfer, and supporting documentation.

14
15 Further, I recommend that Az-Am's request for an accounting order to use the mortgage
16 amortization method of amortizing the acquisition adjustment be denied.

17
18 Q. Does this conclude your direct testimony?

19 A. Yes, it does.
20
21
22
23

24 ⁵ Az-Am's test year weighted average cost of capital.